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Robert Grossman, Group Managing Director
U.S. Public Finance
Fitch Ratings
33 Whitehall Street, 27th Floor
New York, NY 10004

Dear Mr. Grossman:

I am pleased Fitch proposes to "harmonize" its municipal ratings scale with the scale it uses to assign corporate ratings. However, while these are important steps, they are not sufficient. Below are my comments on Fitch's *Exposure Draft: Reassessment of Municipal Ratings Framework*, dated July 31, 2008.

What do ratings measure?

The State of California, like all issuers, makes only one promise to investors: We will pay our debt service on time and in full. Therefore, our rating should only reflect the likelihood we'll keep that promise. That means our ratings should be based on an agency's assessment of the likelihood we will default.

The Exposure Draft is unclear on this fundamental issue. At one point, it states, "Credit risk, as measured by Fitch's ratings on municipal debt obligations, is comprised of both default risk and loss given default." It goes on to say, "At the roundtable discussions, most issuers and investors also voiced the opinion that municipal ratings, particularly at investment-grade levels, should focus primarily on default risk." These statements are consistent with my view.

Unfortunately, the Exposure Draft offers a clarification that undercuts Fitch's purported approach to base ratings on default risk. "Fitch's ratings do not aim to predict specific percentage frequencies (cardinality) of default," the Draft says. "Instead, they aim to present a relative, ordinal scale of creditworthiness." There are two problems with this statement.

First, what is "creditworthiness?" The Exposure Draft does not define it, but implies it is different from default risk. If so, how? And why?

915 CAPITOL MALL, ROOM 110, SACRAMENTO, CALIFORNIA 95814 • (916) 653-2995 • FAX (916) 653-3125

Second, ratings are said to be a *relative* scale. Again, why? If three students score 98%, 99%, and 100% on a test, don't they all get A's? Haven't they all demonstrated mastery of the subject? In the same way, three issuers who all demonstrate an exceedingly low level of default risk should all be able to earn the highest rating. I certainly am not arguing that all municipal bonds receive AAA ratings. But different ratings must signify different degrees of risk. The Exposure Draft notes that since the early 1990s "there have been no defaults on Fitch-rated tax-supported or water/sewer revenue bonds." If so, why are some such bonds rated BBB and others AAA? Relative ratings make sense. But, there must be some absolute standard that distinguishes among rating categories. Fitch has failed to define that in the Exposure Draft.

How can we be sure ratings have been harmonized?

As the Exposure Draft explains, "Harmonizing ratings across different asset classes is a challenging exercise." It adds, "While there are important similarities between municipal issuers and corporate issuers, there are significant differences as well. As such, it is very difficult to formulaically link ratings between the two."

While formulae may be difficult, the alternative presents greater problems. If ratings are assigned on a "relative scale," based on an undefined quality of "creditworthiness," there is no way to assure the market that ratings have been harmonized. Default history may be less than optimal, but it is the best guide to ensure ratings truly have been harmonized.

I agree with the need, as described in the Exposure Draft, to create ratings comparability across two axes: bonds in different sectors with the same rating should represent similar risks; and bonds in the same sector with different ratings should represent different risks. The best way to achieve this objective is to use default rates as the proxy for credit risk. That doesn't mean default rates should be exactly the same for bonds from different sectors that carry the same ratings. But there shouldn't be substantial deviations from that norm. When the five-year cumulative default rate on A-rated corporate bonds is .65%, on BBB-rated corporate bonds is 3.11%, and on BBB-rated municipal bonds is .66%, something is definitely out of whack.

I'm glad Fitch recognizes such default rates require that municipal bond ratings rise to eliminate this inconsistency. I hope Fitch uses default rates as the primary measure of whether there is harmonization. Only adherence to that standard can give the market confidence harmonization has been achieved.

I take serious issue with Fitch's contention that the existing rating distribution of municipal bonds relative to corporate bonds proves there is harmonization or that municipals are rated fairly relative to corporates. While it is true 58% of state and local

GO ratings are in the AA or AAA category, compared to 10.1% for U.S. corporate finance ratings, such a comparison is meaningless given the generally stronger credit quality of GO bonds. Of course there will be a greater concentration of higher ratings among GO bonds, just as there will be more A students among those headed to Harvard than those dropping out of high school. What determines harmonization, instead, is whether bonds with the same ratings represent the same risk, regardless of sector. Fitch's five-year cumulative default rates demonstrate they do not.

"Forward looking" analysis is based on conjecture, not evidence

The Exposure Draft explains that relying solely on historical default rates could fail to anticipate how an issuer will respond to future circumstances. "Consequently," says the Draft, "Fitch believes that both a careful review of the historical record, and a prospective view based on sound credit analysis are necessary to harmonize ratings across asset classes." A successful application of this approach, however, depends on what is meant by "sound credit analysis." If the goal, as described, is for ratings to indicate the likelihood of default, sound credit analysis must be based on factors that have a direct impact on the possibility an issuer will default. And those factors must be based on historical evidence, not mere conjecture. According to the Exposure Draft:

> A variety of challenges, some unprecedented, face municipal issuers going forward that temper expectations for generally strong future credit performance. These include severe housing price declines and record-high fuel costs; simultaneous weaknesses in property, sales, and income tax revenues; expenditure pressures; increased funding requirements for pensions and other post-employment benefits (OPEB); higher expected debt burdens and increased infrastructure needs; dislocations in the credit markets that may affect market access; lower credit quality and constrained capacity of credit enhancement and liquidity providers.

This is a good list of potential budget strains. But government issuers have faced similar problems in the past. The source may be different this time around, but declining revenues and increasing costs have been part of every economic cycle. And, going back nearly two decades, tax-backed issuers rated by Fitch always have paid their debt (presumably what is meant by "strong credit performance"). Further, while the Exposure Draft notes other rating agencies have shown defaults to occur, Moody's studied tax-backed issuers it rated going back to 1970 and found only one defaulted. This period of time includes the most severe economic downturn since the Great Depression. In rating municipal bonds, Fitch must consider this past in any evaluation of the future.

Additionally, any forward-looking assessment should be informed by rigorous studies that justify use of specific factors. No such studies have been undertaken, and I urge Fitch to perform them.

More broadly, Fitch should try to understand *why* tax-backed bond defaults are virtually non-existent, rather than just posit unproven factors that may theoretically lead to defaults. The Exposure Draft says one strength of tax-backed bonds is their "Legal security (unlimited tax general obligation, first lien on pledged tax revenue)." This is key. Tax-backed bonds are extremely safe for investors because they incorporate numerous protections that make the payment of debt service mandatory, not optional. When budget times are tough, issuers do not have the option to not pay debt service.

Summary

I am disappointed Fitch proposes to increase tax-backed ratings by only one to two notches. It will leave many issuers who never have defaulted – and never will default – saddled with unjustifiably low ratings. Further, I see no reason why bonds currently rated A+ or higher will get a one-notch upgrade, while lower rated bonds will get two. The rationale for this approach is unclear. I hope Fitch will continue to evaluate the way it rates municipal bonds and make more improvements soon.

Sincerely,

Bill Lockyer

BILL LOCKYER
California State Treasurer